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- How to spot the ax using Level 2

Main Points:

In this lesson you will learn how to spot who the "ax" is using a Level 2 screen. The "ax" is the market maker who, at this particular moment (eg for this 3- to 15-minute timeframe) is either buying or selling the most stock. We'll look at how to trade with the ax in the next lesson; this lesson shows you how to spot who the ax is.

- **MM ECN Routing headfake:** MMs will frequently disguise their intentions by routing their orders through INCA or ISLD. See through this ruse by determining how strong the buy/sell action is on the inside bid/ask w/INCA or ISLD...eg if you see the inside ask stay firm w/INCA or ISLD you know some market maker is working a large order and that the situation is "indeterminate" or low-percentage to enter a trade. Wait until a clearer signal is available to enter the trade.
- **Spotting the ax on Level 2:** As we've learned already, First always keep an eye on MSCO MLCO SBSH and GSCO; these are your "first picks" to see which of them are the ax at a given point in time. The second indicator is the "number of times at best" inside bid/ask AND (more importantly) the refresh rate or 'depth' of their buying or selling when they are at the inside (that's what T&S is for). A third indicator is the "trade box" they are playing, eg where is their bid/ask spread on level 2. A final indicator is the # of times they are at the first outside (green) band on level 2. This lesson covers these four areas.
- **Following the MM Axe to Daytrade:** Even with the ECN routing that mm's use to hide their order flow, there's still plenty of profitable trading to be had by correctly: #1) Avoiding buying when a major mm/ax is selling (eg if you see MSCO and MLCO both sitting on the inside ask you probably shouldn't buy if their bid is 3 levels outside the market) and #2) "Shadowing" a the ax's buying/selling behavior, if you see that all else looks okay, eg no suspiciously strong ECN buying/selling on INCA/ISLD.

Examples:

Four Ways to Spot the Ax on Level 2

When the stock is not being moved around primarily by daytraders on ECNs (like DLCK is) or a mm routing order flow through ECNs, consider following one of these four main mms as one of your primary indicators.

Let's study an example of NETA from Thursday, January 6th, where MSCO is the ax.

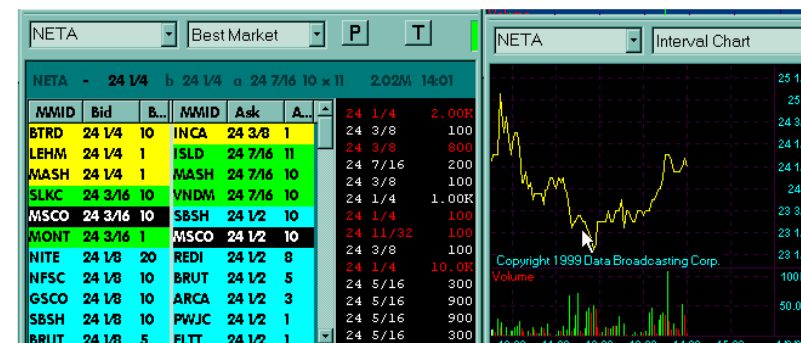
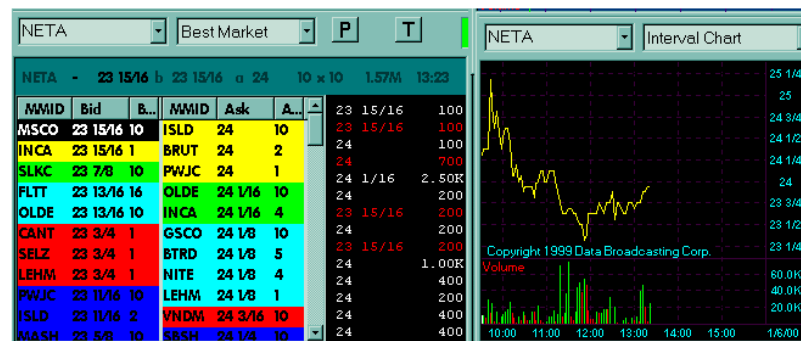
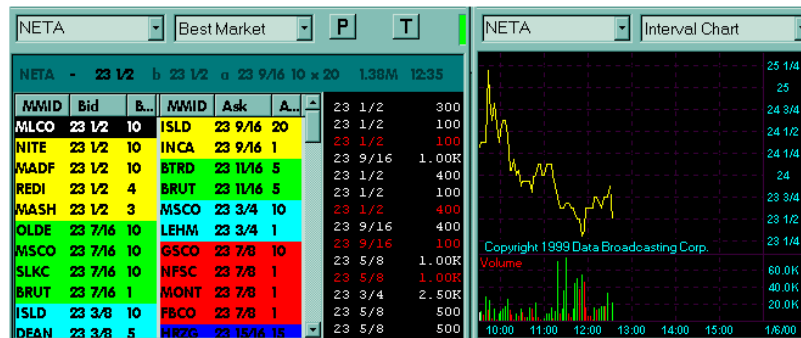
Noticing unusual volume at lunchtime, we see a trend reversal at 12pm...BUY signal generated at 23 1/2 here on volume pivot.

In the first box, I highlighted MLCO, thinking he might be the ax. He dropped out entirely though, leaving MSCO on the bid (2nd).

Third box, we see our initial scalp SELL signal as a volume spike at 24 3/8 followed by a lower high/lower low.

P/L = +7/8 points profit in an hour trade. NETA went on to close at 24 1/2. Nice ride.

MSCO is the ax on this, we saw him stay on the inside (or 1 level outside/green) bid all the way up.



#2: Number of Times at Best (Inside) Bid/Ask

Ok, now we know [who](#) to look for, now let's look at [how to interpret](#) their position in the level 2 box.

This indicator is simply looking at the ratio of times the market maker you believe is the 'ax' is buying vs selling stock visibly on the inside bid or ask in a given time period.

Let's say in the box to the right that I've been watching this stock for the last hour or so and SBSH keeps popping up on the inside bid. Further, I see in Time and Sales that he buys at least 5000 shares of stock in 200-1K trade sizes every time he's there.

Sure, he fades to an outside bid level now and then, but overall he's buying and let's say the stock is holding it's own (or even a slight uptrend) in a down market. I'd look to buy the stock when the market starts to head back up if SBSH is still on the inside bid.

Also, as a mental 'checklist' item, at least do not go against one of the four major mm's who is refreshing his bid/ask repeatedly. Example: I don't short SPLS when MSCO is on the inside or green band, as he tends to hold SPLS up, and SPLS has up days whenever he's on the inside (at least the last 6

MMID	Bid	B...	MMID	Ask	A...
SBSHc	27 3/16	10	INCAc	27 1/4	10
GSCOc	27 3/16	10	ISLDc	27 1/4	1
PACSc	27 3/16	1	MONTc	27 1/4	1
ISLDc	27 1/8	9	NITEc	27 5/16	1
SWCOc	27 1/8	1	MADFc	27 3/8	10
NITEc	27 1/8	1	PACSc	27 3/8	1
MASHc	27 1/8	1	DAINc	27 3/8	1
WBLRc	27 1/8	1	SELZc	27 3/8	1
SLKCc	27 1/8	1	LEHMc	27 3/8	1
FBCOc	27 1/8	1	SLKCc	27 3/8	1
BESTc	27	10	SHWDC	27 7/16	10
INCAc	27	4	GKMCc	27 7/16	1
MADFc	27	1	MLCOc	27 1/2	20
GKMCc	27	1	HRZGc	27 1/2	18

We look at the Number of Times at Best (some software will calculate/display this for you), to try and determine if this mm is a net buyer or seller.

The caution, of course, is that they may try to appear to be buyers when they're really selling thru INCA or ISLD.

One tip for this: Trade stocks with less skilled market makers on them. In choosing stocks to play, find ones that trade on lower average daily volume (let's

months of '99 to present).

say 700K-2M, \$25-\$40 share price range), as they are likely to have a market maker dividing his attention trading it and 4-5 other issues simultaneously. Headfakes are more common with popular stocks, as the major firms put their best traders on them.

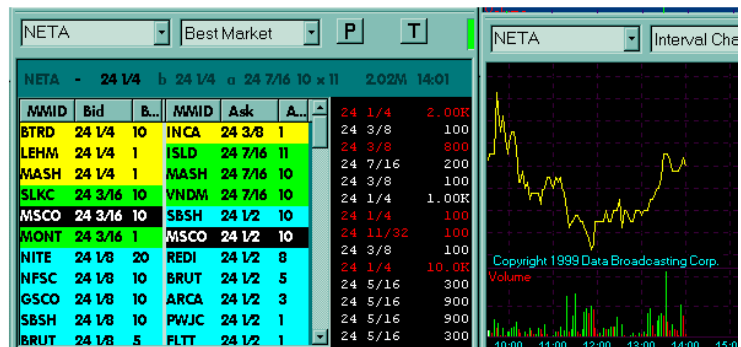
#3: Market Makers' Trade Box

Looking at our NETA example again, you can see MSCO's "trade box" is:

Bid 24 3/16 x Ask 24 1/2

for the moment. This is a **5-spread trade box**, telling you he's not particularly bullish or bearish on this stock **publicly** (again, watch ECN order flow for disguised order routing).

FYI, trade boxes of 2-5 spreads are common; what you want to watch for is both the **width** of the ax mm's trade box (does he suddenly go from 3 spreads wide to 6?), and the **bid/ask direction** of where he's parking his trade volume. That is, is he 4 spreads wide but on the inside (say at 24 1/4 bid NETA x 24 7/8 ask). This can clue you in as to the direction that this mm thinks the stock will go in.



Trading note: having a very intense focus is critical to success in daytrading. Make sure you know the behavior of the "4 major mms" for 3-5 stocks that you follow like the back of your hand. As you know, I like NOVL SPLS DCLK SBUX for daytrading, there are many others out there.

#4: Action in the First Outside (Green) Band

The first outside level in your L2 window is important to follow, it's kind of a 'leading indicator' within the micro-world of the L2 box alone. Again, T&S and market / sector direction are the most important indicators, the L2 box is for closely timing your trade entries and exits only (not overall trend determination).

Think of the green band on the bid as your "escape hatch" for and the "wall of sellers to get through" on the ask.

What do the two different examples here (to the right and below) tell you about relative buying and selling in these two stocks, DELL and VRTY?

Can you exit a trade more safely in DELL or VRTY, based on what the L2 green bands alone are telling you?

Answer is DELL of course, you have 7 mms on the green bid, only an ISLD 2 green on VRTY.

DELL	-	S3 9/16	b	S3 9/16	a	S3 5/8 20 x 30	36.1M	14:55
MMID	Bid	B...	MMID	Ask	A...			
ISLD	S3 9/16	20	ARCA	S3 5/8	30		S3 9/16	100
INCA	S3 9/16	14	ISLD	S3 5/8	30		S3 5/8	1.00K
ARCA	S3 9/16	10	NTRD	S3 5/8	10		S3 5/8	300
BEST	S3 9/16	10	INCA	S3 11/16	10		S3 9/16	100
NITE	S3 9/16	5	NFSC	S3 11/16	10		S3 5/8	700
NWSE	S3 1/2	54	NITE	S3 11/16	5		S3 9/16	300
SBSH	S3 1/2	10	REDI	S3 11/16	2		S3 5/8	100
SHWD	S3 1/2	10	PIPR	S3 11/16	1		S3 5/8	1.00K
RAMS	S3 1/2	10	BTRD	S3 3/4	214			
DEAN	S3 1/2	10	MLCO	S3 3/4	22			
MSCO	S3 1/2	10	SHWD	S3 3/4	10			
MADF	S3 1/2	2	WARR	S3 3/4	10			
SLKC	S3 7/16	10	SBSH	S3 3/4	8			
DLIP	S3 3/8	10	PERT	S3 3/4	7			

Daytrading Play w/Green Band on L2: Use it to help you with scalping. I use it to decide if I should stop out of a position if buyers aren't coming in like I thought they would. If the green band starts to evaporate, I'll sell at market bid 2-3 minutes before the stock price starts to drop. Likewise, if the green ask band starts to get thin, then I may enter a new long position in expectation that the price will bounce up 2-3 spreads before settling in, at which point I may scalp out (frequent) or use a trailing stop for a 30-minute to 2-hour trade (10-20% of my trades).



Hopefully, these tips will help you become more comfortable using Level 2 screens correctly. All of these subtleties are necessary to daytrade for a living, yet no website or book I've seen tells you these important tips.

They should all make sense, there is much more to tell you about, let's press on to the next lesson... >>